



## CHAPTER 6

# Audit

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*Auditing is broadly defined as the independent examination of an entity's records or actions to evaluate compliance with financial, legal, contractual or policy requirements.*

Agency contract managers and contractors are responsible for complying with federal and state requirements in the performance of client service contracts. This responsibility includes having an audit when required by law or by contract. Audit requirements exist for federally funded programs (refer to OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations at [www.whitehouse.gov/OMB/circulars](http://www.whitehouse.gov/OMB/circulars)). When writing contracts, agencies have the option to call for an audit beyond those required by law.

An audit can be designed to accomplish one or more of the following:

- Provide reasonable assurance as to the financial information reported by or obtained from the contractor;
- Assess the financial condition of a contractor;
- Assess the internal control system of a contractor;
- Assess the performance of a contractor; and
- Assess compliance with applicable laws and contract provisions.

Is an audit different from monitoring? Yes. An independent party usually completes an audit, while state agency staff involved in the contracting process typically conducts monitoring. Audits are conducted according to standards, such as the Generally Accepted Auditing Standards or GAAS, while monitoring generally involves review of contractor compliance with contract terms and conditions. Audits result in a published report and typically occur after the contract is completed. Monitoring occurs while the contract is ongoing and may be documented through internal report.

When contemplating audits not required by law, contract managers should consider the level of need for an audit of state or federal funds. As with program monitoring, contract managers are encouraged to use a risk assessment process to determine the need for audit coverage of client service contractors.

When an audit is deemed appropriate and necessary, the expectations for the audit scope, methodology and due date should be included in the written contract. Typically, the contractor hires the auditor. However, contract managers may hire auditors for state funded contracts. For information about procuring an audit, refer to [Appendix E](#).

While an audit can be an effective tool in demonstrating accountability, it carries a cost. Therefore, it is important that care be exercised in calling for audits. For information on specific types of audits that may be utilized with contractors, refer to [Appendix F](#).

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### 6.1 What to Audit and When - Using a Risk Assessment Approach

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When state or federal law does not require an audit, contract managers should consider the benefit of an audit. The decision should be based on a risk assessment, which includes consideration of the risk associated with the program and the contractor; the sensitivity of the program; and an understanding of all funding received by the contractor. State agencies should develop methods of assessing risk.

**Risk Associated with the Client Service Program and the Client Service Contractor:** Guidance on developing and using risk assessment criteria based on the risk associated with the program and the risk associated with the contractor is provided in Chapter 1, Contract Management, Risk Assessment Approach to Contract Management section.

**Sensitivity of the Program:** These factors can be broken into four major areas:

- **Complexity** – Is the program funded by multiple state agencies?
- **Consequences of Non-Performance** – If the contractor failed to perform, would the state agency be unable to meet a legislative mandate or its agency mission? Could it result in a loss of significant federal, state or other funding? Would it result in a loss of opportunity for providing or improving existing services?
- **Impact on the Public** – Does the program require the contractor to have direct contact with the public, including benefits to, payment by, and transactions with clients? Does the contractor have indirect impact on the public, including making decisions that are viewed as important by the public?
- **Impact on State Operations** – Does the contractor's performance have a statewide or multiple agency impact? Is the impact limited to a single state agency or a work group within a state agency?

**Funding Received by the Contractor:** Before making a decision on whether to audit a given contractor, contract managers should gain an understanding of all funding received by the contractor. This enables contract managers to better assess the risk associated with overlapping program objectives and funding sources.

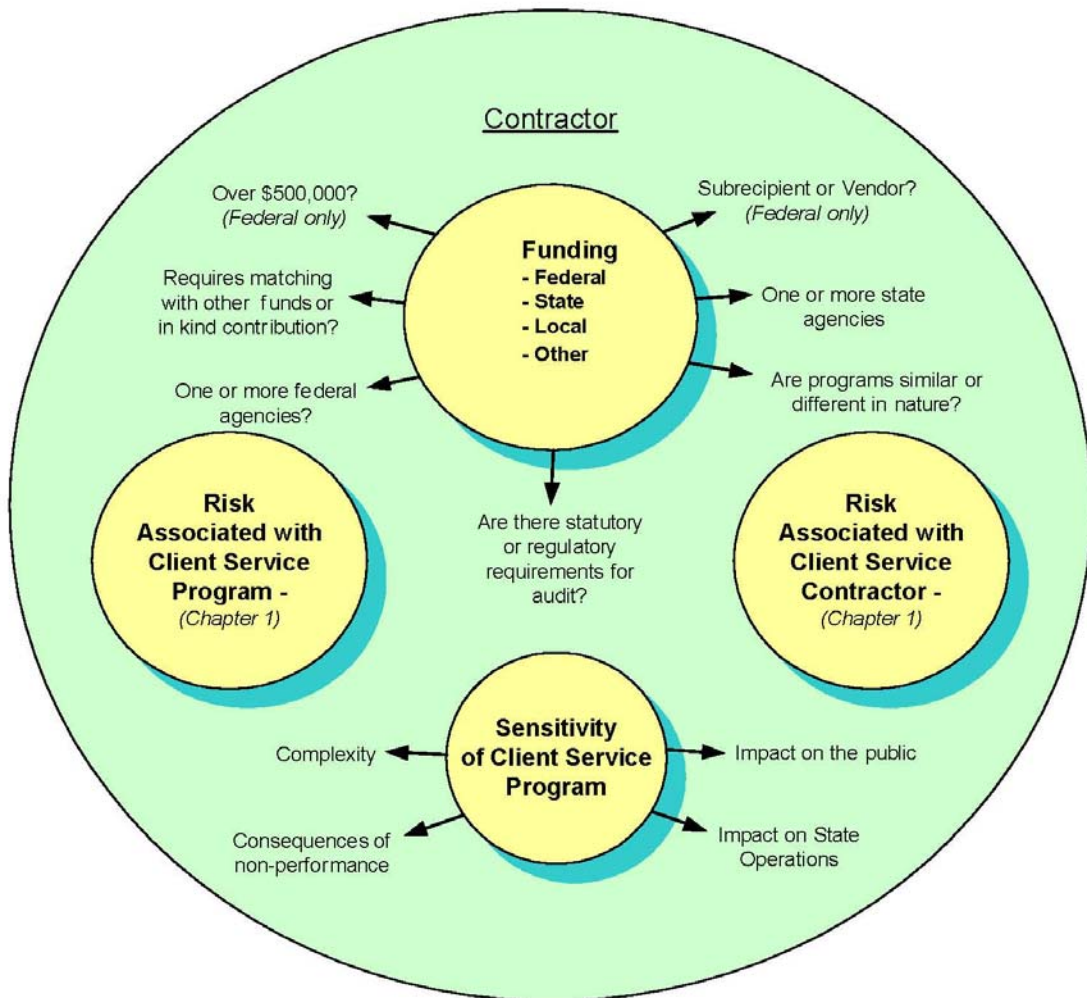
Some questions to ask in identifying funds received by the contractor are:

- **Does the contractor have matching requirements?** Federal or state programs may require contractors to spend money on program objectives, in addition to the funding provided in the contract. These matching requirements are frequently met with private or other funds or in-kind services.
- **Is the contractor a subrecipient or vendor under the contract?** Please refer to the Chapter 2, Pre-Contract Planning, Federally Funded Contracts section.
- **Is the contractor a subrecipient, expecting to spend more than \$500,000 in federal funds during its fiscal year, including contracts awarded by other state agencies or other entities?** If the contractor is expected to spend more than \$500,000 in federal funds, they are subject to OMB Circular A133 Audit requirements. If not, they still may be subject to an audit requirement imposed by the entity providing the funds.
- **Does the contractor have state funded contracts awarded by other state agencies?** To make effective use of limited resources, contract managers should coordinate audit efforts, whenever possible.
- **Is funding that is provided to the contractor material in relation to the program?** Would an error or misappropriation of funds have an impact on the success of the program regardless of the \$500,000 federal threshold?
- **Has monitoring disclosed ongoing problems in under or over spending with various categories or timelines?** If so, this could indicate a problem not disclosed by monitoring alone.

The OFM Client Service Contracts Database (CSCD) may be helpful to state agency staff in determining other fund sources received by contractors through various state agency contracts. This is especially important when considering federal funds and whether contractors are above the \$500,000 threshold.

**Refer to the following page regarding risk factors for audits.**

## Risk Factors



### **6.3 Making the Decision to Audit**

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Once an assessment has been made of the risk associated with the program, the risk associated with the contractor, the sensitivity of the program, and an understanding of all funding received by the contractor, contract managers should have the information necessary to make a decision on whether to require an audit. Contract managers should decide how to distribute their audit resources among contractors, based on the relative risk and sensitivity. The decision should include the type and scope of audits to be performed.

To make the most effective use of resources, contract managers should then determine the extent to which the contractor is subject to financial, compliance and special purpose audits, and what will be covered by these audits so as not to duplicate audit work. However, contract managers should bear in mind that such audits might not include coverage of areas of concern to the agency. Contract managers should contact other agencies to coordinate audit efforts.

In coordinating audit efforts with other state agencies, questions to consider include:

- ✓ Does the contractor receive both state and federal funds from other state agencies?
- ✓ Does the contractor receive only state funds from other state agencies?
- ✓ Are federal contract expenditures under \$500,000 per year?
- ✓ Does the contractor subcontract with other entities? Were the subcontracted entities audited?
- ✓ Do different agency programs have the same fiscal period?
- ✓ Are the programs sufficiently similar to use common audit techniques?
- ✓ How is the funding distributed?

### **6.4 Reading an Audit Report**

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Generally, an audit report includes opinions from the auditor, in addition to the entity's financial statements and any findings. The auditor's opinions include a "scope" paragraph and an "opinion" paragraph, although they are usually not labeled as such.

The scope paragraph may state that the scope was limited for the following reasons:

- ✓ The auditor was engaged to look at only a portion of the contractor's activities;
- ✓ The auditor did not have full access to the contractor's records;
- ✓ The auditor was not independent of the contractor being audited;
- ✓ There was a lack of sufficient documentation to audit; and
- ✓ Other limitations were imposed on the auditor by the contractor, which restricted the auditor's ability to perform the audit in accordance with auditing standards.

If a contract manager is reading an audit report and the scope paragraph states there was a limitation in the scope of the audit, the contract manager should consider whether this adversely affects the value of the audit to the agency's program. In addition, consideration should be given to whether the limitations in scope are an indication that the contractor is not able to, and did not, deliver the contracted client services. If so, contract managers may need to consider terminating the contract.

If there was no limitation in the scope of the audit, the scope paragraph will generally state the name of the contractor, the time period audited, and that the audit was conducted in accordance with generally accepted auditing standards. This type of scope paragraph indicates the auditor was able to perform a complete audit according to generally accepted auditing standards.

The opinion paragraph of the auditor's report gives the auditor's opinion about the results of the audit, the conclusion as to the fairness of the financial statements, and the contractor's compliance with requirements established by the contract and/or internal controls and financial reporting requirements. When the auditor gives an opinion about the financial statements, the auditor states whether the financial statements are presented fairly in accordance with generally accepted accounting principles or GAAP.

Audit opinions are sometimes very complex. Opinions may be "unqualified," meaning the auditor has determined the financial statements were fairly presented in accordance with GAAP. Opinions may also be "qualified," "adverse," or may contain a "disclaimer of opinion," that could indicate problems with the contractor's ability to deliver client services.

These exact words may not be used, so it is advisable to seek advice from agency audit staff or other knowledgeable personnel as to the type of audit opinion.

Findings are written by the auditor to identify problems noted during the audit that require resolution. Generally, a finding is written when there is non-compliance with the contract terms or with federal or state laws or regulations or when a material internal control weakness exists. Generally, the auditor will provide the contractor an opportunity to respond to the finding and include the contractor's response with the text of the finding when published. Recommendations are written by the auditor as part of a finding to give the contractor suggestions on how to resolve the finding and avoid future occurrences.

A finding can include questioned costs. Questioned costs are normally those costs associated with an audit finding that are determined by the auditor to be unallowable contract charges.

Sometimes the auditor will not write a finding but instead will report a problem in a separate management letter to the contractor. Generally, management letters are written to report less significant problems and are not included in the audit report.

Contract managers should consult with agency accounting or auditing staff for further guidance.

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## **6.5      Audit Resolution**

State agencies should establish a process for dealing with resolution of the audits where findings and/or questioned costs exist. If federal funds are involved, OMB Circular A-133.315 requires follow up and corrective action on all federal findings. The audit resolution process should also be addressed in the contract.

### **6.5.1    Decisions Regarding Findings**

State agency management should make a decision regarding whether findings in an audit report are substantive enough to warrant resolution.

Normally, if a finding exists in a published audit report, whether issued by Federal auditors (Office of Inspector General or OIG), an independent CPA firm, the State Auditor's Office or a state agency's internal audit staff, resolution of audit findings is warranted.

An audit resolution process might include the following:

- ✓ Written notification to the contractor of the audit finding(s);
- ✓ Opportunity for the contractor to respond to the finding by a concurrence or non-concurrence with the finding(s); or
- ✓ Opportunity for the contractor to submit further documentation or reasons for non-concurrence with the finding(s).

State agency management may decide to sustain an audit finding or not require corrective action based on the information received during the resolution process. The agency should document its process and decisions.

### **6.5.2 Corrective Action**

As part of the resolution process, contractors may be required to submit a corrective action plan to contract managers. The corrective action should be comprehensive and in sufficient detail to resolve the finding and prevent future occurrences. Corrective actions may or may not include the auditor's recommendations. Questioned costs, if applicable, should be addressed in the corrective action plan. For federal funds, OMB Circular A-133.315 may require reporting to the federal government. For further information, refer to Chapter 5, Contract Monitoring, in the ***Corrective Action*** section.

### **6.5.3 Appeals**

Generally, the contractor should be given an opportunity to appeal the consequences of a management decision about an audit finding before an objective third party. State agency procedures should allow for appeals of management decisions regarding audit findings and questioned costs. Contract managers should contact their assigned Assistant Attorney General for assistance with developing, writing or implementing appeal processes and any other questions about appeals.

### **6.5.4 Handling Questioned Costs**

Questioned costs are normally those costs associated with an audit finding. These costs can be handled in several ways.

First, a decision on whether or not to pursue recovery of the questioned costs should be made. There may be good reasons not to pursue recovery of the questioned costs. While this is an option, there must be compelling reasons and authority, generally based on Assistant Attorney General guidance, to exercise this option.

Options for recovering questioned costs may include:

- ✓ Billing the contractor;
- ✓ Adjusting future payments until the questioned costs have been recovered; and
- ✓ Deducting the questioned costs from the final payment.

Contracts dealing with federal funds may require different processes. Also, it is important to note that when recovering questioned costs, the repayment by the contractor is generally not an allowable cost for current contracts.

#### **6.5.5 Lack of Resolution of Audit Findings**

If resolution is determined to be required, either through a management decision process or appellate process, contract managers should be prepared to take action for failure of a contractor to complete resolution.

If a contractor fails to resolve the conditions of the audit finding, contract managers may want to consider one or more remedies or sanctions listed in *Chapter 2, Contract Provisions*. Contract managers may consider imposing additional requirements on the contractor when the contractor fails to resolve the finding.

The contractor should be notified in writing of the nature of corrective action needed and the time allowed for completing the corrective action. If applicable, the written notification should include a description of how the contractor may request reconsideration of any additional requirements. Once the contractor completes the corrective action, any special conditions should be promptly removed from the contract.

Contract managers may want to consider terminating the contract if the contractor's failure to resolve the finding has a material effect on the contract. The termination notification to the contractor should be in writing and should be sent to the appropriate parties to the contract in accordance with the termination conditions outlined in the contract. Contract managers should provide contractors the opportunity for a hearing, an appeal or other administrative proceeding under applicable statutes or regulations when it is determined that the contractor has failed to resolve the finding.